AP Macroeconomics
Test: Macroeconomic Variables
Instructor's Version

Answers: Free-Response Questions

1. Circular Flow

A. The circular flow model or diagram presents a picture of how money flows through an economy. Within this flow, there are both injections and leakages.

I. What are the three types of injections? (3 points)

Answer: Investment (I), government spending (G), and exports (X)

1 point for each.

II. What are the three types of leakages? (3 points)

Answer: Savings (S), taxes (T), and imports (M)

1 point for each.

B. Consider an economy in which Y =2200, C = 800, G = 600, S = 400, and NX = 200. Find investment and taxation. (2 points)

Answer: I = 600; T = 600

1 point for each answer.

C. Consider an economy in which I = 1000, S = 1000, T = 400, G = 600, and NX = 0.

I. Explain why this economy is not in equilibrium. (2 points)

Answer:
Part 1: The financial markets are imbalanced because it is not true that I - S + (T - G) + NX.

Part 2: This is because taxation (T) is less than government spending (G).

Part 2 alternative: The amount flowing out of financial markets is greater than the amount flowing in.

1 point for each part, with credit given for either version of part 2.

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II. What is needed to return this economy to equilibrium? (3 points)

Answer:
Part 1: To bring the market into equilibrium, there must be fewer dollars going out of financial markets and more going in.

Part 2: This economy can be returned to equilibrium if government spending is brought down to the level of taxation so that there is more money flowing into the financial market.

Part 2 alternative: This economy can be returned to equilibrium with higher interest rates, which would increase capital flowing into the financial market.

1 point for part 1; 2 points for either version of part 2.

2. Describe the difference between nominal GDP and real GDP, and explain why nominal GDP can increase constantly even when real GDP increases *and* decreases. (6 points)

Answer:
Description: Nominal GDP is calculated using current prices. Real GDP uses constant prices that are fixed in a base year (in other words, real GDP adjusts prices for inflation).

Explanation: Because of inflation, prices are constantly increasing, so nominal GDP can go up while real GDP goes up and down.

2 points for each sentence in description; 2 points for the explanation.

3. Long-Term Growth

A. What are four things real GDP does NOT adjust for? (4 points)

Answer: Population changes, distribution of income, externalities, and types of production

1 point for each.

B. List four ways that the PPF can be shifted outward. (4 points)

Answer: Increases in labor, increases in land, increases in capital, and technological advancements

1 point for each.

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4. The Business Cycle

A. When is an economy contracting and when is it expanding? (4 points)

Answer: An economy is contracting when real GDP is going from a peak to a trough. An economy is expanding when real GDP is climbing out of a trough to another peak.

2 points for each sentence.

B. Describe the four types of unemployment. (4 points)

Answer:
1. Structural unemployment is caused by the types of production and by the laws of an economy that govern whose skills are valuable in the marketplace.
2. Frictional unemployment is associated with workers changing jobs, often because workers are searching for better opportunities or moving to a new location.
3. Cyclical unemployment is caused by changes in real GDP that are associated with the business cycle.
4. Seasonal unemployment is caused by changes in employment associated with changes in the seasons.

1 point for each.

C. Define *inflation* and explain how inflation is measured. (5 points)

Answer:
Definition: Inflation is a general increase in prices throughout an economy.

Explanation: Inflation can be measured by calculating changes from year to year in the consumer price index (CPI). The CPI is calculated using the price for a market basket of goods that remain the same.

2 points for the definition; 2 points for the first sentence in the explanation; 1 point for the second sentence in the explanation.

D. Describe the two types of inflation. (6 points)

Answer:
1. Demand-pull inflation is caused by consumers increasing their demand for goods and services. Some of the things that change demand are tastes, income, population changes, and future expectations.
2. Cost-push inflation is usually caused by increased costs of making goods and services. Increased costs come from increased wages or resource costs.

For each type of inflation: 2 points for the first sentence, 1 point for the second sentence.

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